

State Investment Commission
Minutes
December 13, 2005

The State Investment Commission was called to order by Jonathan Miller, State Treasurer, on Tuesday December 13, 2005 in Room 76 of the Capitol Annex at 9:00 a.m. Members present were Tim LeDonne, proxy for Robbie Rudolph, Secretary, Finance and Administration Cabinet; Andy Hightower, proxy for Governor Ernie Fletcher; and Jonathan Miller, State Treasurer.

Treasurer Miller verified that a quorum was present and that the press had been notified of the meeting.

A motion was made by Mr. LeDonne and seconded by Mr. Hightower to accept the minutes of the September 26, 2005 meeting. Motion **CARRIED**.

Steve Jones, Portfolio Manager, Office of Financial Management, presented an update on the TRAN. Mr. Jones stated that each year money is borrowed for one year and invested. Mr. Jones indicated that the Commonwealth borrowed \$600 million in Tax and Revenue Anticipation Notes on July 1, 2005 with a maturity date of June 28, 2006 at an all-in cost of funds of 2.67 percent. Mr. Jones stated that an interest rate swap in the amount of \$538,000,000 was entered into on which the Commonwealth received 3.81 percent on the fixed side of the transaction and invested the proceeds. Mr. Jones indicated the interest rate on the Notes was 2.67 percent which results in approximately a 100 basis point spread. Mr. Jones further indicated that when comparing the investments to the floating side of the swap, the Commonwealth has earned approximately \$1.4 million through November 30, 2005. Mr. Jones indicated that when comparing the debt versus the fixed side of the swap the Commonwealth has made approximately \$1.4 million for a total of approximately \$3 million. Mr. Jones noted that the fee is held by the Commonwealth and is available for various purposes. Mr. Jones stated that the TRAN is on track and predicted that total earnings on the TRAN will be approximately \$6 million by the end of the fiscal year.

Mr. Jones indicated that originally the portfolio was on a mark to market basis in which prices for each of the securities would be pulled in each day and the change in price would be included as income. Mr. Jones explained that the ALCo authorization which created the TRAN actually authorized a book value basis. Mr. Jones stated that as a result staff began recording the portfolio on a book value basis and adjusted the portfolio accordingly. Mr. Jones indicated that once that was completed, it became apparent that the pricing service was not doing a good job of pricing CMO floaters and that the Commonwealth had taken a paper loss (accounting loss) which wasn't real. He further indicated that when the portfolio was recorded on a book value basis, the income was captured and resulted in an increase in October. Mr. Jones indicated that this was an accounting issue and would be resolved by the end of the year.

Mr. Dwight Price, Portfolio Manager, Office of Financial Management, discussed BondEdge software. Mr. Price stated that BondEdge is a software package that is being used to analyze the Commonwealth's portfolio. Mr. Price indicated that the software generates a printout similar to the one found in Attachment B of the agenda. Mr. Price stated that the printouts show the contents of each particular portfolio (Bond Proceeds and Intermediate). He continued that the Bond Proceeds

Pool consists of Treasury and Agency securities and the Intermediate Pool consists of corporate bonds, taxable munis, Agency securities, CMOs and asset backed securities. Mr. Price indicated that he compares the effective duration and convexity of the Commonwealth's pools against the Index to see how well they are performing.

Treasurer Miller asked what the banks listed at the end of the printout represent. Mr. Price indicated the banks are part of the Kentucky Bank Repurchase Program and the Linked Deposit Program. Mr. Price indicated there is no risk to the Commonwealth with these programs as they are backed by eligible securities and/or Abandoned Properties. Mr. Price indicated that only three or four banks have most of the participation in this program. He pointed out that the Cabinet for Economic Development is considering a change in governing legislation that would make the program more attractive to them and he has suggested that they contact the Treasurer's Office regarding changes in the legislation.

Mr. Hightower asked if there was a total cap on the program. Mr. Price indicated that at this time there is not a cap on the program. Mr. Price added that if a cap were to be placed on the program at this time, it would be the value of the abandoned properties program.

Mr. Price further stated that the BondEdge software allows staff to analyze buying, selling, and swapping securities to compare them against the Index.

Mr. Jones discussed a new position that was put into place in December. He indicated that the yield curve is extremely flat. He further commented that the spread between the difference in the yield on a two-year treasury and a five-year treasury has been running about one or two basis points over the past two weeks and five year swaps have been running about eight basis points. Staff felt that the curve will steepen in the near future and that would have a negative effect on the Commonwealth's portfolio. Mr. Jones indicated that for that reason, steps were taken to make money if that should actually happen. Mr. Jones stated that the easiest and most efficient way to accomplish this was in the interest rate swap market. Mr. Jones stated that two interest rate swaps were entered into at exactly the same time: the first swap was for \$25.5 million dollars and would receive a fixed rate of 4.85 percent for the next two years versus paying 3 month LIBOR; the second swap was for \$10 million and the Commonwealth is paying 4.94 percent for five years versus receiving 3 month LIBOR. Mr. Jones stated that if you hold a longer maturity bond and interest rates rise, the value will drop more than a shorter maturity bond. Jones indicated that \$23.5 million versus the \$10 million creates a balance and the value of this position net between the two swaps will not change. Mr. Jones indicated that he would hold an interest rate swap class for anyone who would be interested in attending.

Mr. Hightower asked if a flatter curve indicated that the two year interest rate swaps would hedge above the five year interest rate swaps. Mr. Jones indicated this was correct and the Commonwealth could lose money on trade.

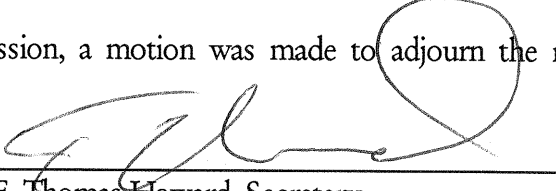
Mr. Price stated that he had one additional item to discuss that was not on the agenda which was an update on the University of Kentucky hospital program. Mr. Price indicated that consideration is being given to using the long-term pool to invest a substantial amount of cash flow (estimated \$150

December 13, 2005

million) for the University. Mr. Price indicated that in the past the long-term pool held \$600-800 million which included Transportation Cabinet moneys and the state's "Rainy Day Fund". He further indicated that the pool was closed because the Transportation Cabinet spent all but \$200 million and the Rainy Day Fund did not have sufficient deposits to warrant longer term investments. Mr. Price indicated that UK will have an additional \$150 million within the next year to be invested in the pool.

Mr. LeDonne asked what happened to the Transportation Cabinet's \$200 million. Mr. Price indicated the Cabinet had approved and started many additional projects. Because of the additional projects added to the list Transportation's balances decreased dramatically. Mr. Price stated that the Cabinet had to pay the IRS arbitrage on the borrowed funds when the money was not expended in the required two years so more projects were funded and the balance in the long-term pool decreased. Mr. Jones pointed out that the TRAN pool is an exception to the arbitrage regulation if the Commonwealth achieves a deficit of 90 percent of the amount borrowed within six months of issuance.

With no further business before the Commission, a motion was made to adjourn the meeting. Motion **CARRIED**.



F. Thomas Howard, Secretary
State Investment Commission